SUPREME COURT, U. S.

Office-Supreme Court, U.S.
FILED
FEB 4 1966
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 987

JOHN F. NUTT and EILEEN M. NUTT, *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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Petitioners pray for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in the above-entitled case.

OPINIONS BELOW

The opinion of the Tax Court is reported at 39 T.C. 231. The opinion of the court of appeals is reported at — F. 2d — and is reprinted in Appendix A, *infra.*

JURISDICTION

The judgment of the court of appeals was entered on October 1, 1965 (Appendix A, *infra*, p. 5a). On November 9, 1965, the court of appeals denied the petition for rehearing which had been filed by petitioners on October 30, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. Sec. 1254.

QUESTION PRESENTED

Whether a leasehold held for a term of more than six months and used in the taxpayer's trade or business constitutes "property used in the trade or business" within the meaning of that phrase as used in Section 1231(b)(1) of the Internal Revenue Code of 1954.

STATUTE INVOLVED

The statute involved, Section 1231(b) of the Internal Revenue Code of 1954, is set forth in Appendix B, *infra*, p. 6a.

STATEMENT

During 1955 petitioner John F. Nutt, a farmer, was the lessee of several parcels of farm acreage. The landlords were Dorothy Zook, Fidel Salazar, Henry Wagner, and Frances Nutt, the petitioners' adult daughter. Petitioner farmed the land covered by each lease. Each lease was for a term in excess of six months and each lease had been held for more than six months. On August 30, 1955, petitioner sold to Black Land Farms, Inc., an Arizona corporation, for the sum of $94,656.87 the leaseholds on the Zook, Salazar, Wagner and Frances Nutt farms. The gain on the sale of the leaseholds was and is claimed as gain realized from the sale of "property used in the trade or business" of

petitioner as that phrase is used in Section 1231(b)(1) of the 1954 Internal Revenue Code. However, both the Tax Court and the court of appeals denied petitioners the benefit of Section 1231(b)(1). The rationale of both decisions was that since a leasehold is not land, it does not qualify as "property used in the trade or business" as such phrase is specifically defined in Section 1231(b)(4) of the 1954 Internal Revenue Code.

REASONS FOR GRANTING THE WRIT

The leasehold here constituted "property used in the trade or business" within the meaning of that phrase as found in Section 1231(b)(1) of the 1954 Internal Revenue Code. The reason is that such leaseholds were property used in the trade or business of petitioner of a character subject to the allowance for depreciation provided in Section 167 of the 1954 Internal Revenue Code and held for more than six months. *Robert Treat Hotel Co.*, 20 BTA 968 (1930); T.D. 3760, IV-2 CB 154; *Hotel de France Co.*, 1 BTA 28 (1924); *Newmarket Co.*, 2 BTA 537 (1925); *The Hub, Inc.*, 3 BTA 1259 (1926); *Newman*, 10 BTA 158 (1928); *Crandall Horse Co.*, 8 BTA 1132 (1927); *Opperman Coal Co.*, 6 BTA 1215 (1927).

Petitioners claim the benefits of Section 1231(b)(1). They did not[1] and do not claim the benefits of Section 1231(b)(4). Therefore, to rule as the court of appeals did, that leaseholds are not land within the meaning of

[1] That petitioners did not claim the application of Section 1231(b)(4) is shown by the fact that they did not add to the cost basis of the leaseholds the cost of raising the crops on the leaseholds as is required by Section 268, and by the briefs filed in the Tax Court and the court of appeals.

the term "land" as found in Section 1231(b)(4) on the strength of *Bidart Bros.* v. *United States,* 262 F. 2d 607, is not enough to support a holding that the subject leaseholds are not "property used in the trade or business" as defined in Section 1231(b)(1). Yet that is the effect of what the court of appeals did.

The decision of the court of appeals conflicts with the decisions of other circuits which recognize that a leasehold constitutes "property used in the trade or business" and that any profit realized from the sale thereof is entitled to capital gain treatment. *Commissioner of Internal Revenue* v. *McCue Bros. & Drummond, Inc.,* 210 F. 2d 752 (2d Cir., 1954); *Commissioner of Internal Revenue* v. *Louis W. Ray et ux.,* 210 F. 2d 390 (5th Cir., 1954); *Commissioner of Internal Revenue* v. *Golonsky,* 200 F. 2d 72 (3rd Cir., 1952).

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Nos. 18,950 and 18,951

JOHN F. NUTT and EILEEN M. NUTT, *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

[October 1, 1965]

On Petitions for Review of the Decision of the Tax Court of the United States

Before: CHAMBERS, POPE and JERTBERG, Circuit Judges.

CHAMBERS, Circuit Judge:

John and Eileen Nutt, husband and wife, residents of Eloy, Arizona, are farmers. They seek review here of twin decisions of the Tax Court adverse to them. In August, 1955, as the cotton harvesting season was approaching they formed two Arizona corporations. One was Rancho Tierra Prieta and the other was Black Land Farms, Inc.

To Tierra Prieta, they promptly transferred about 1,150 acres of land owned in fee as community property under the laws of Arizona. Along with it went the cotton crop. The crop was worth far more than the land because the Nutts retained their wells and well sites upon which the annual crops were dependent for irrigation water. As consideration for the sale, a nominal payment of cash was made and large purchase money notes and mortgages were executed. In due course, the notes were paid and the mortgages discharged. No part of the sale price was represented by corporate stock of Tierra Prieta. However, 152 shares

of stock were issued in exchange for new money paid it. Apparently, John Nutt wrote a check for $7,500 and received 75 shares of common stock with par value of $100 per share. Likewise, Eileen Nutt did the same thing and received the same number of shares. Norman Nupen, the family bookkeeper, and Charles N. Walters, their lawyer, each received one share of preferred nonvoting stock, par value. They seem to have paid a hundred dollars each.[1] The directors were John Nutt, Eileen Nutt and Nupen. At this point, it is apparent the taxpayers were seeking to avoid a tax free transfer into the corporation and were seeking to get the potential substantial profit on the cotton crop into capital gains rather than be left with high federal income tax brackets. This is fine if it works, bad if it does not.

In a similar arrangement, with variations as to capital structure, the taxpayers, John and Eileen, sold their lessees' side of short term farm leases they held on neighbors' lands to Black Land. The unharvested crop went along with the leases. The leases were appraised at little more than the value of the growing crops.

The taxpayers would treat a sale of a leasehold with a growing crop the same as the sale of fee land with a growing crop, giving capital gains tax treatment to the entire

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[1] Among the exhibits in the record, one finds a duplicate deposit ticket of the First National Bank of Arizona, Eloy office, dated August 28, 1955, listing checks deposited as follows:

J. F. Nutt	$7,500.00
Eileen Nutt	7,500.00
Chas. Walters	100.00
N. C. Nupen	100.00

These amounts are contemporaneous with and correspond exactly to the amounts of the respective stock subscriptions of the four individuals.

purchase price received by the seller.[2] The argument is well put together, but we hold that our previous decision in Bidart Bros. v. U. S., 262 F.2d 607, cert. den. 359 U.S. 1003, completely precludes petitioners here and we are unable on the leaseholds sold to Black Lands to distinguish this case as they do from Bidart.

Now we must return to Tierra Prieta, the commissioner and the Tax Court having charged the Nutts individually with the profit on the cotton crops as ordinary income. (The same was done on Black Land.) The Nutts for the years here in question filed separate tax returns, each taking half of the income as his, a rather common and permissible practice in community property states such as Arizona.

One reason given by the commissioner and the reason assigned by the Tax Court was that the taxpayers, John and Eileen, had a right to reacquire the land the crops were on directly or indirectly, and had thus run afoul of Regulation 1.231-1(f)[3] under the Income Tax Code of 1954.

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[2] Sec. 1231 of the Internal Revenue Code of 1954 provides for capital gains treatment on the sale of certain property used in a trade or business and with reference to crops subsection (b)(4) thereof says:

> "(b)(4) Unharvested crop.—In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as 'property used in the trade or business.'"

[3] The regulation provides as follows:

> "(f) Unharvested crops. Section 1231 does not apply to a sale, exchange, or involuntary conversion of an unharvested crop if the taxpayer retains any right or option to reacquire the land the crop is on, directly or indirectly (other than a right customarily incident to a mortgage or other security transaction). The length of time for which the crop, as distinguished from the land, is held is immaterial. A leasehold or estate for years is not 'land' for the purpose of section 1231."

However, most of the commissioner's pitch before the Tax Court was that the transaction was a sham and should be disregarded. He produced some pretty good evidence on the point. But the Tax Court found against him on that, and he has not petitioned here for review. Much of the government's brief is devoted to argument of the shallowness of the transactions. But the point was lost before the Tax Court and the point is gone.

Absent the husband and wife situation, the commissioner does not suggest that two chummy equal "partners," owning as tenants in common the land that was transferred to Tierra Prieta, assuming bona fides and no sham, could not have received capital gains treatment on the transaction. And, we think such persons could have obtained capital gains treatment.

What is really missing from the whole voluminous record, the opinion of the Tax Court, and the briefs here is how was the stock of the corporations owned and what were the incidents of such ownership. We would not accept the common-law concepts of the husband being the master of the house and of his wife's property or that because Mrs. Nutt was the wife it could be presumed she would always do what Mr. Nutt wanted done. We know the presumption that that which is acquired during coverture in a community property state is presumed to be community property and we know the exceptions.[4] But here on the sketchy record, the stock certificates of John and Eileen could have been separate property of each. Or both certificates could have been community property. And there are other combinations. If the certificate in the name of Eileen was community property, did John have a legal right to tell her how to vote it? Could he dispose of that certificate?[5] All of

[4] See Arizona Revised Statutes, 1956, Section 25-211.

[5] Under Section 10-231 of the Arizona Revised Statutes Eileen Nutt could have disposed of the stock registered in her name. And, John Nutt could have sold the stock registered in his name.

these may be Arizona legal niceties. It is evident that the facts are yet explorable, and we hold we are justified in asking the Tax Court to find out the facts on the stock ownership and apply its concept of the Arizona law thereto. This is of great importance on Tierra Prieta and minor on Black Land.

We do not accept petitioner's contention that Sec. 1.1341-1(f) of the Regulations is invalid as wholly made up by the commissioner without any roots in the statute. Section 1231 of the 1954 Code, a capital gains section, had its counterpart in the 1939 Code.[6] The challenged subsection of the Regulations had its equivalent before 1954.[7] We think this is one case where the Congress in 1954, if it had not liked the regulation, would have changed it.

We think the regulation really defines what is a substantial sale. As indicated, the commissioner has lost his point on whether the transaction was a sham generally, but he still has his point on whether there was an indirect right to reacquire the land.

The case is remanded for proceedings in accordance with this opinion.

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[6] See Section 117(j)(3) of the Internal Revenue Code of 1939, 1951 Amendment, Section 323, 65 Stat. 452.

[7] See Treasury Regulations 118, Section 39.117(j)-1-(d).

APPENDIX B

Statute Involved

Internal Revenue Code of 1954:

Section 1231 (b)

"(b) Definition of Property Used in the Trade or Business.—For purposes of this section—

(1) General Rule.—The term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in paragraph (3) of section 1221.

(2) Timber or Coal.—Such term includes timber and coal with respect to which section 631 applies.

(3) Livestock.—Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(4) Unharvested Crop.—In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as "property used in the trade or business."

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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioners were the lessees of several parcels of farm land. On August 30, 1955, they sold the leaseholds along with the mature but unharvested crops growing on them to a corporation, the stock of which was owned by petitioners and their daughter. The sale price totalled $97,856.87, of which $94,656.87 represented the appraised fair market value of the unharvested crop and $3,200 the appraised fair market value of the unexpired leases. Petitioners reported their profit from the sale as long-term capital gain. The Commissioner determined deficiencies which, so far as pertinent here, were premised on the ground that the portion of the sales price attributable to the unharvested crops was taxable as ordinary income

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rather than as capital gain. The Tax Court sustained the Commissioner and the court of appeals affirmed on the basis of its previous decision on the same issue in *Bidart Bros.* v. *United States,* 262 F. 2d 607, certiorari denied, 359 U.S. 1003 (Pet. 1a–5a.)[1]

Absent a statute to the contrary, this Court has held that the proceeds derived from the sale of crops—whether or not sold along with the land and whether or not harvested—are taxable as ordinary income rather than as capital gain. *Watson* v. *Commissioner,* 345 U.S. 544. Congress has changed that result only to the extent set forth in 1954 Code § 1231(b)(4),[2] *i.e.,* a taxpayer is entitled to capital gain treatment on the proceeds received from sale of a crop only if he sells an unharvested crop along with the land on which it is growing and he has held the land for more than 6 months and used it in his trade or business. Of controlling importance for present purposes is the fact that the statute applies only to a sale of "land" with growing crops attached. Here petitioners sold leaseholds. The Treasury Regulations have for many years provided that the statutory word "land" in § 1231(b)(4) does not include a leasehold. See Treasury Regulations

[1] In the lower courts the case also involved a sale of land (as contrasted with leaseholds) with unharvested crops, but the petition for certiorari does not raise any issue with regard to that transaction.

[2] Section 1231(b)(4) provides:

> In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as "property used in the trade or business."

118, § 39.117(j)-1(d); Treasury Regulations on Income Tax (1954 Code), § 1.1231-1(f). During this period Congress reenacted the provision verbatim in the 1954 Code.

Petitioners assert (Pet. 3) that the $3,200 *received for the leasehold* should be accorded capital gain treatment under 1954 Code Section 1231(b)(1). The Commissioner does not quarrel with this contention.[3] The instant case is concerned, however, with the taxation of the $94,600 *received for the growing crop.* This amount could receive capital gain treatment only under § 1231(b)(4), not under § 1231(b)(1). See *Watson* v. *Commissioner,* 345 U.S. 544.

The judgment below is correct, there is no conflict of decisions, and the question is not of general importance. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted.

THURGOOD MARSHALL,
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Attorneys.

APRIL 1966.

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[3] In the Tax Court the Commissioner argued that the entire sale was a sham. The Tax Court rejected that contention and held that only the proceeds allocable to the sale of the crops were taxable as ordinary income. Since the Commissioner did not appeal, the Tax Court's decision that the petitioners were entitled to capital gain treatment on the $3,200 received for the leaseholds is now binding.

U.S. GOVERNMENT PRINTING OFFICE: 1966

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PETITIONERS' REPLY BRIEF

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PETITIONERS' REPLY BRIEF

The trial court, in findings of fact which were left undisturbed by the court of appeals, found that: (1) the "agreed consideration for the leaseholds of the land upon which the unharvested crops were growing was $97,856.87";[1] (2) "petitioners assigned these leaseholds";[2] (3) $97,856.87 was "paid" to "petitioners pursuant to the terms of the written agreement for sale of leaseholds";[3] and (4) "of the $97,856.87 considera-

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[1] R. at 208.

[2] R. at 208.

[3] R. at 209.

tion for the assignment, the sum of $94,656.87 represented the fair market value of the unharvested crop and $3,200 represented the fair market value of the unexpired leases."[4] The Commissioner of Internal Revenue, as was recited in the trial court's opinion, "by amendment to his answer . . . and in the alternative alleged that if the sales are recognized, the portion thereof *attributable* to unharvested crops is taxable to petitioners as ordinary income under the provisions of section 1231 (b) (4) of the Internal Revenue Code of 1954."[5] It was this alternative contention which the trial court sustained after expressly recognizing that it was petitioners' position that they "assigned leaseholds to Black Land and did not sell unharvested crops to it."[6]

Therefore, it is grossly inaccurate for the Commissioner of Internal Revenue to have "answered" the petition for a writ of certiorari by stating in his memorandum in opposition that petitioners assert that the $3,200 *received for the leasehold* should be accorded capital gain treatment under 1954 Code Section 1231 (b) (1)". First, petitioners have always asserted that it is the $97,856.87, which the trial court found as fact had been paid for the leaseholds, that is entitled to the benefits of Section 1231 (b) (1). That is what this case is all about, and the effort to portray it as respondent attempted, after having obtained a thirty day extension of time within which to file its two page memorandum, is tantamount to an admission that he is unable to meet the petition

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[4] R. at 208.

[5] R. at 218.

[6] R. at 223-224.

on the merits. Second, the trial court did not find that $3,200 was *received for the leasehold* and $94,000 was *received for the growing crop* as the Commissioner states. Instead it sustained respondent's alternative position that the portion of the $97,856.87 sale price "*attributable* to unharvested crops is taxable to petitioners as ordinary income under the provisions of section 1231 (b) (4)."[7]

In short, what has happened here is that petitioners, who are entitled to the benefits of section 1231 (b) (1), as enacted for them by the Congress, have been deprived of that Congressional grace by the Commissioner who has broken up their sale of leaseholds into parts, made something out of it different from what it was, and then proceeded to tax the transaction as he remade it.

The implicit rationale of the lower courts' holdings and respondent's memorandum in opposition is that upon the sale of a leasehold qualifying as "property used in the trade or business", as defined in section 1231 (b) (1) of the 1954 Code, the seller is required under *Watson* v. *Commissioner,* 345 U.S. 544, to comminute "the sale price into its fragments and these are to be separately matched against the definition in" section 1231 (b) (1) and section 1231 (b) (4). This must be so because although the trial court found as fact that petitioners assigned the leaseholds for an agreed consideration of $97,856.87 which was paid, it nevertheless concluded it could *attribute* that portion of the value of the leaseholds represented by the value of the unharvested crops growing on the land covered by the leaseholds ($94,657.87) and tax that portion of the sum received for the leaseholds as ordinary income

[7] R. at 224.

under section 1231 (b) (4). That is, a section added to the law long after section 1231 (b) (1) had been enacted, namely section 1231 (b) (4), and for the purpose of granting additional benefits to taxpayers, was invoked to take away from taxpayers a benefit they had been entitled to under section 1231 (b) (1).

There is no case law or statutory authority for the proposition that upon the sale of a leasehold under section 1231 (b) (1), the underlying assets are to be individually examined in order to determine whether or not each is entitled to capital gain treatment under section 1231 (b) (1).

If the Commissioner of Internal Revenue wishes to change the law that upon the sale of a leasehold the seller is entitled to capital gain treatment, he should be required to ask Congress to act. He should not be allowed to do so by administrative interpretation.

CONCLUSION

The petition for a writ of certiorari should be granted.

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